

# Interest-Only Mortgage Tutorial

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Here is what you will learn in this tutorial:

1. What is an interest-only mortgage?
2. For what types of borrowers is it suitable?
3. What are the hazards you should watch out for?
4. What information do you need to assess an IO mortgage?
5. How do you get this information?

## What Is An Interest-Only Mortgage?

A mortgage is "interest only" if the scheduled monthly mortgage payment – the payment the borrower is required to make – consists of interest only. The option to pay interest only lasts for a specified period, usually 5 to 10 years. Borrowers have the right to pay more than interest if they want to.

If the borrower exercises the interest-only option every month during the interest-only period, the payment will not include any repayment of principal. The result is that the loan balance will remain unchanged.

For example, if a 30-year loan of \$100,000 at 6.25% is interest only, the required payment is \$520.83. In contrast, borrowers who have the same mortgage but without an IO option, would have to pay \$615.72. This is the "fully amortizing payment" – the payment that would pay off the loan over the term if the rate stayed the same. The difference in payment of \$94.88 is "principal", which goes to reduce the balance.

For a more complete illustration of the difference between an interest-only and a fully-amortizing mortgage, see [Interest-Only Versus Fully Amortizing.](#)

## For What Types Of Borrowers Are Interest-Only Mortgages Suitable?

Interest-only mortgages are for borrowers who have a valid use for a lower initial required payment, and are prepared to deal with the consequences.

***Pay Principal When Convenient:*** Borrowers with fluctuating incomes may value the flexibility the IO mortgage gives them. When their finances are tight, they can make the IO payment, and when they are flush they can make a substantial payment to principal.

Ask yourself whether you are disciplined enough to make the payment to principal when you aren't obliged to.

***Buy More House:*** It is common for families to begin with a "starter house", then move into a more expensive house as their incomes rise. This process of "trading up" carries high

transaction and moving costs.

You can avoid these costs by skipping to the second house now. In the short term, this will cause a cash flow strain, but the IO mortgage may make it manageable.

Ask yourself whether you are comfortable with the risk that the expected higher income won't materialize.

***Invest the Cash Flow:*** For most homeowners, paying down mortgage debt is the most effective way to build wealth. Nonetheless, some may build wealth more rapidly by investing excess cash flow rather than paying down their mortgage. For this to succeed, their return on investment must exceed the mortgage interest rate, since that rate is what they earn when they repay their mortgage.

A valid example is the young borrower with a long time horizon who invests in a diversified portfolio of common stock. This should generate a yield of 9% or more over a long period. Another are business owners who might earn a high return investing in their own businesses.

Ask yourself whether you really will invest the excess cash flow, as opposed to spending it; and whether you have a firm basis for believing that your investments will yield a return higher than the mortgage rate. I don't recommend it as a wealth-building strategy for most borrowers. See [Is Unused Home Equity a Missed Fortune?](#)

***Quick Capital Gain:*** An interest-only (IO) is the instrument of choice in a quick turnover situation if you are trying to maximize the amount of house you can buy, and are limited by your income. The IO option lowers the required initial payment, which allows you to qualify for a larger loan amount.

This is why buyers in markets undergoing strong price appreciation, who are looking for quick capital gains, gravitate to IOs – or to their big brother, the flexible payment (option ARM), which has even lower payments in the first year than an IO. See [Questions About Option \(Flexible Payment\) ARMs](#).

The more expensive the house they can buy, the larger the expected capital gain. However, if you don't need an IO to qualify for the house you want to buy, it is not the best choice in a quick turnover situation. See [Is Interest-Only Best For a Quick Turnover?](#)

***Allocate Cash Flow to Second Mortgage:*** John Doe finances his home purchase with an 80% fixed-rate mortgage (FRM) at 5.5%, and a 20% HELOC at 7.75%. The FRM is IO, and Joe uses all his available cash flow to pay down the balance on the HELOC. This makes sense because of the higher rate on the HELOC, and the possibility of future rate increases.

***Payment Responsive to Principal Reduction:*** On most IO loans, whether fixed or adjustable rate, the monthly mortgage payment will decline in the month following an extra payment. This is the only type of mortgage that has this feature. On a conventional FRM, the payment never changes while on ARMs, the payment doesn't change until the next rate adjustment.

Some borrowers find this feature extremely convenient. For example, a home purchaser who must close before his existing house is sold may want to use the proceeds of the sale, when it occurs, to reduce the payment on the new mortgage. On many but not all IOs,

a large extra payment reduces the payment in the following month

On some IOs, however, the payment doesn't change until the anniversary month, and on others it does not change until the end of the IO period. If you are contemplating an interest-only loan and find immediate payment adjustments in response to extra payments a highly desirable feature, ask about it. See [When Will Extra Payments Reduce Monthly Payments?](#)

### What Hazards Should You Watch Out For?

The major hazard is being deceived into accepting an interest-only mortgage that does not meet any of the suitability tests described above. The deceptions are about alleged desirable features of IOs that don't in fact exist.

Borrowers can immunize themselves against most deceptions by remembering one critical fact. If two mortgages are identical except that only one has an interest-only option, lenders view that one as riskier. The reason is that, after any period has elapsed, the loan with the IO option will have a larger balance.

**Deception 1: *An interest-only loan carries a lower interest rate.*** Lenders usually charge a higher rate for an identical loan with an interest-only option, for reasons indicated above. I have never seen a price sheet in which a lender quotes a lower rate on an identical loan with an IO option, though I am told it happens; this is not a perfect market.

The deception arises from comparisons of apples and oranges. Most interest-only loans are adjustable rate mortgages (ARMs), and ARMs have lower rates than fixed-rate mortgages (FRMs). ARMs with the IO option have lower rates than FRMs because they are ARMs, not because they are IO.

**Deception 2: *An interest-only loan allows the borrower to avoid paying for mortgage insurance.*** Since loans with an IO option are riskier to the lender, the option cannot cause the disappearance of mortgage insurance.

Any IO loans with down payments less than 20% that don't carry mortgage insurance from a mortgage insurance company are being insured by the lender. The borrower is paying the premium in the interest rate rather than as an insurance premium.

**Deception 3. *On an ARM with an interest-only option, the quoted interest rate is fixed for the interest-only period.*** It may or may not be. The interest-only period is the period during which you are allowed to pay interest only, usually 5 or 10 years. The period for which the initial rate holds can be as long as 10 years or as short as one month.

Where the initial rate period is 3, 5, 7 or 10 years, the interest-only period is likely to be the same. Where the initial rate period is a month, 6 months or a year, the interest-only period will probably be longer. These are the cases where deception is most likely to arise.

**Deception 4. *It is less costly to amortize an interest-only loan.*** This is patently ridiculous, but some variant of it keeps popping up in my mail.

There is no magic connected to amortizing an interest-only loan. A borrower who takes an interest-only option but decides to make the fully amortizing payment instead will amortize in exactly the same way as the borrower who takes the same mortgage without the option.

Read [Does an an Interest-Only Amortize Faster?](#)

### What Information Do You Need To Assess An IO Mortgage?

ARMs have the advantage of carrying a lower interest rate, and lower monthly payment, in the early years than fixed-rate mortgages (FRMs). But because the ARM rate is adjustable, it may rise in later years, and the payment will rise with it. Intelligent decisions about ARMs, therefore, require that account be taken of what might happen when the initial rate period ends.

While future interest rates are not known, we can make assumptions about what will happen to rates; these are called *interest rate scenarios*. Usually, we focus on rising rate scenarios, because those are the ones we worry about.

For any given scenario, we can calculate exactly how high the rate and mortgage payment will go, and when it will get there. This is scenario analysis. We can also calculate the total cost over any period specified by the borrower. In assessing ARMs with an IO option, borrowers will want to compare scenarios with and without the option.

When ARM rates are much lower than FRM rates, shrewd borrowers may take an ARM but make the payment that they would have had to make had they taken an FRM. By paying the balance down faster, the cost imposed by rising rates in the future is reduced. Hence, it is useful to perform scenario analysis based on the assumption that the borrower pays at the FRM rate for as long as that payment is larger than the ARM payment.

This is an alternative to an IO, and based on the opposite premise. Where an IO attempts to minimize the borrowers payments in the early years, for any of the reasons noted earlier, the FRM payment option is designed to pay down the balance as much as possible in the early years.

To see a sample of rates/payments and costs on an ARM, with and without both the interest-only and FRM payment options, click on [Sample Rates/Payments and Costs](#).

### How Do You Get This Information?

You get it in two steps. In step 1, you have your loan officer or mortgage broker provide the essential data on the features of each loan you are considering. To make it as easy as possible for them, print out and give them [Worksheet of ARM Features](#).

Step 2 involves transferring the data on ARM features into the [ARM Tables calculator](#) which will generate your tables.

Have your data in hand before clicking on ARM Tables calculator above or selecting the ARM Tables calculator on the Tutorials Menu.